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No. 06-870

In the Supreme Court of the United States

CROWN PAPER LIQUIDATING TRUST,
Petitioner,

v.

PRICEWATERHOUSECOOPERS, et al.,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

BRIEF OF *AMICUS CURIAE*, NATIONAL ASSOCIATION OF BANKRUPTCY TRUSTEES, IN SUPPORT OF PETITIONER, CROWN PAPER LIQUIDATING TRUST

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MOTION FOR LEAVE TO FILE A BRIEF IN SUPPORT OF PETITIONER CROWN PAPER LIQUIDATING TRUST[1]

Consent to file this amicus brief was requested in writing from counsel for the parties on January 17, 2007. All consents were not received as of January 18, 2007, at which time it was necessary to submit this brief for printing and binding.[2]

The movants are the National Association of Bankruptcy Trustees ("NABT"), a nonprofit association formed to address the needs of bankruptcy trustees throughout the country, and to promote the effectiveness of the bankruptcy system as a whole. There are approximately 1,250 bankruptcy trustees currently receiving new cases, and over 900 of them are NABT members. In addition, there are approximately 225 associate members, including judges, United States Trustees, auctioneers, appraisers, insurance agents, bankers, attorneys and accountants who frequently work with trustees.

Robert C. Furr is an attorney licensed to practice in the State of Florida. He is also a Chapter 7 Panel Trustee in the Southern District of Florida, and a member of the Board of Directors and Vice President of NABT.

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[1] No other person or entity, except for amici curiae, their members and their counsel, made a monetary contribution to the preparation and submission of this brief.

[2] In the event all consents are received by the required filing date, January 22, 2007, the NABT will file such consents with the Court. If any party expressly withholds consent, that information will also be filed.

Jeffrey Davis is a Professor of Law at the University of Florida Levin College of Law. He has taught bankruptcy law for thirty-two years. He has spoken at and participated in panel discussions in numerous state and national bankruptcy conferences. He has also written a number of articles in the area of bankruptcy law, including a recent article germane to this case. See Davis, Jeffrey, *Ending the Nonsense: The In Pari Delicto Doctrine has Nothing to Do With What is § 541 Property of the Bankruptcy Estate*, 21 Emory Bankruptcy Developments Journal, 519 (2005).

IMPORTANCE OF THE QUESTION PRESENTED

The pattern has become all too familiar. The managers of a corporation concoct a scheme to defraud the investing and lending public. They enlist the help of third party accountants, law firms, and public relations professionals, who falsely certify that the enterprise is both legitimate and solvent. Eventually, the wrongful scheme comes to light and the corporation is driven into bankruptcy. The losses suffered by creditors and investors are substantial, sometimes enormous. In this case, the losses exceed one-half billion dollars.

As this Court pointed out in *Commodity Futures Trading Comm'n v. Weintraub,* 471 U.S. 343, 352 (1985), " Upon Commencement of the case in bankruptcy, all corporate property passes to an estate represented by the trustee. 11 U.S.C. §§ 323, 541. The trustee is 'accountable for all property received, §§ 704(2), 1106(a)(1), and has the duty to maximize the value of the estate, *see* § 704(1)." Accordingly, the trustee in bankruptcy pursues the managers and the third-party facilitators, who have enriched themselves at the expense of the estate only to be told that because their wrongdoing is attributable to the corporation, the wrongdoers

are not liable for the harm done. Though they lament the result, the Circuit Courts of Appeal uniformly say their hands are tied, because they believe the Bankruptcy Code requires that the wrongdoers go free of liability.

The Circuit Courts are incorrect. Their hands are not tied, and it is now clear that only this Court can right this devastating wrong by making clear that trustees in bankruptcy indeed have the authority to impose liability on these wrongdoers. In this brief, Amicus Curiae NABT respectfully explains where the Circuit Courts have gone wrong, and how this Court can put the matter right.

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SUMMARY OF ARGUMENT

The issue in this case is whether the *in pari delicto* defense can be invoked by the erstwhile managers and fiduciaries of now bankrupt Crown Paper Company against Crown's trustee in the bankruptcy simply because the defense would theoretically have been available had Crown sued these same managers and their cohorts under state law. As stated by the Federal District Court below, and affirmed without opinion by the Ninth Circuit Court of Appeals, "[E]very Circuit to have considered the question has held that in pari delicto can be asserted against a trustee bringing a claim on behalf of a debtor in bankruptcy." *In re Crown Vantage, Inc., 2003 WL 2527821 (Reproduced in Petition for Writ of Certiorari, Appendix B,* at 18a.) NABT respectfully submits that this conclusion can only be reached by ignoring eighty years of case law in which this Court has unfailingly held that the question of what is property of the estate is a matter of **federal law** to be determined in light of **federal bankruptcy policy.** This was well settled law when the new Bankruptcy Code was enacted in 1978, and nothing in the Code or its legislative history suggests that Congress had any intention to change it.

No court has suggested that asserting the *in pari delicto* defense against a trustee in bankruptcy makes good sense or policy. Rather the courts all take the erroneous position that this result is mandated by Section 541, which defines property of the estate, and their hands are tied. NABT respectfully submits that Section 541 mandates no such thing, and that in determining as a matter of federal law what is property of the estate, courts must consider federal bankruptcy policy. In doing so, it becomes clear that the *in pari delicto* defense should not be available against a trustee in bankruptcy to protect from liability those managers and

their third-party cohorts who have enriched themselves at the expense of the bankrupt corporation and its innocent creditors and investors. The Circuit Courts of Appeal have uniformly failed even to consider this important rule of law, making it imperative that this Court set the record straight.[3]

ARGUMENT

I. FROM THE DAWN OF MODERN BANKRUPTCY LAW THIS COURT HAS UNFAILINGLY HELD THAT PROPERTY OF THE ESTATE IS A MATTER OF FEDERAL LAW TO BE DETERMINED IN LIGHT OF FEDERAL BANKRUPTCY POLICY.

The original Bankruptcy Act, Ch. 541, 30 Stat. 550 (1898), was enacted in 1898. Not five years later this Court was called upon to determine the meaning of Section 70(a)(5) of the Act which defined property of the estate as all property which, prior to the filing, the debtor could have "transferred or which might have been levied upon and sold under judicial process against him...." (*Id.* § 70(a)(5).) In *Page v. Edmunds,* 187 U.S. 596 (1903), the question was whether a membership in the Philadelphia Stock Exchange was an asset

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[3] In *Official Comm of Unsecured Creditors of PSA, Inc., v. Edwards*, 437 F. 3d 1145, 1151-52 (11th Cir. 2006), *cert. den.* 127 S. Ct. 45 (2006), the Eleventh Circuit Court of Appeal cited Professor Davis' article, Davis, Jeffrey, *Ending the Nonsense: The In Pari Delicto Doctrine has Nothing to Do With What is § 541 Property of the Bankruptcy Estate*, 21 Emory Bankruptcy Developments Journal, 519 (2005). Although the article prominently states the argument contained in this brief and cites the body of this Court's cases on which the argument is based, the Eleventh Circuit neither acknowledged the argument nor considered the import of the cases.

of the estate. Memberships were limited in number, conferred only after a complex election process, and transferrable only if all debts to members were paid. Because of these limitations, the Supreme Court of Pennsylvania had twice held a seat on the exchange was not property and not subject to execution. *Pancoast v. Gowen,* 93 Pa. 66 (1879), *Thompson v. Adams*, 93 Pa. 55 (1879). Despite these rulings, this Court held the membership was property. *Page v. Edmunds* at 596. Affirming that the issue was one of federal law, this Court stated that the Pennsylvania Supreme Court "expresses no rule with which we need to take issue or which is relevant to the pending controversy. Nor indeed if the case may be construed more broadly. The Bankruptcy Act of 1898 has made its own rule." *Id.* at 604.

In *Segal v. Rochelle,* 382 U.S. 375(1966), this Court again made clear that what is property of the estate is a federal question. At issue was whether a loss-carryback tax refund was property of the estate. The Court stated that it must be guided by the policy of the Bankruptcy Act, and decided that such a refund was not property of the estate because the refund was little entangled with the bankrupt's abilty to make a fresh start, an important bankruptcy goal. *Id.* at 379. Cases subsequent to *Segal* continued to look to bankruptcy policy as a matter of federal law in resolving questions as to what is property of the estate. In *Lines v. Fredrick,* 400 U.S. 18 (1970), this Court held unpaid vacation pay to be property of the estate, emphasizing that "the problem of classification for purposes of the Bankruptcy Act could not be resolved simply by reference to the time when the right to payment vested, or to definitions of property drawn from other areas of law." *Id.* at 19-20. In *Kokoscka v. Belford,* 417 U.S. 642 (1974), this Court held a debtor's income tax refund was not property of the estate because it was sufficiently rooted in the debtor's prebankruptcy past. *Id.*

at 651-62. Again the Court emphasized, "[i]n determining the term's scope–and limitations– the purposes of the Bankruptcy Act 'must ultimately govern.'" *Id.* at 645 *quoting Segal.*

Most recently, this Court again spoke to the issue in *Butner v. United States*, 440 U.S. 48 (1979), just as the new Bankruptcy Code went into effect. The case nicely illustrates the duality of the inquiry into both state law, from which ordinary concepts of property are derived, and federal policy, which is a critical determinant of what is property of the bankruptcy estate. In *Butner*, state case law varied as to the steps a mortgagee was required to take in order to obtain a security interest in rents from the mortgaged property. A minority of courts had adopted a uniform federal approach because of their perceptions of the demands of equity. *Id.* 55. The Court described the two-pronged approach to be taken in an often-quoted passage: "Property interests are created and defined by state law. *Unless some federal interest requires a different result*, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." *Id.* at 55, (emphasis added). The question to be decided, then, was whether the state-to-state variations offended some federal interest. The court reversed the practice of the minority courts in rejecting state law since they had "not done so because of any congressional command or because their approach [served] any identifiable federal interest." *Id.* at 56. Clearly, where there is no federal interest in need of protection, bankruptcy law "recognizes and enforces the [property] laws of the states [such as those] affecting dower, exemptions, the validity of mortgages, priorities of payment, and the like." *Id.* at 54. Equally clearly, however, where important federal bankruptcy policies are undermined, state law must take a back seat.

The NABT respectfully asserts that as the new Bankruptcy Code went into effect, it was well settled that the question of what is property of the bankruptcy estate is a matter of federal law to be determined by, of course first taking into account existing state law, but assuring also that strict application of state law does not offend federal bankruptcy policy. If such a conflict is presented, state law must give way to federal policy concerns. Otherwise, federal bankruptcy policy is defeated, not advanced, by application of *in pari delicto* to trustee. (See Section III, below.)

Such well established pre-Code law surely endures unless there is some indication that Congress in adopting the new Bankruptcy Code intended to change it. There is no such indication.

II. THERE IS NO INDICATION, EITHER IN THE LANGUAGE OF § 541 OR IN ITS LEGISLATIVE HISTORY, THAT CONGRESS INTENDED TO CHANGE THE FUNDAMENTAL CONCEPT OF WHAT IS PROPERTY OF THE ESTATE.

In adopting § 541, Congress spoke both specifically and generally. For the most part, the section speaks specifically, bringing into the estate certain types of property, such as property acquired through the exercise of the trustee's avoiding powers, § 541(a)(3), and certain property acquired within the six months after bankruptcy, § 541(a)(5). It also excludes a long list of specific types of property under subsection (b), as well as spendthrift trust property in subsection (c)(2). The broad general statement lies in subsection (a)(1), as follows:

> (a) The commencement of a case under ...this title creates an estate. Such estate is comprised of all the

> following property, wherever located and by whomever held:
>
> (1) ....all legal and equitable interests of the debtor in property as of the commencement of the case.

This general statement tells us that the legal and equitable interests of the debtor *in property* are property of the estate regardless where located and by whom held. It also tells us *when* to make this determination, as of the commencement of the case, and in so doing creates the greatest and most important exception, cutting post-bankruptcy property out of the estate. Notably, § 541 says nothing about *what is property*, nor how this complex matter is to be determined. The section simply assumes we know, or that we will go about figuring it out as we always have done. There is surely no indication of any intent to change existing law here, and most assuredly no intent to convert the inquiry into one solely of state law. Nothing in the language of § 541 would support a departure from existing law.

Furthermore, the skimpy legislative history of the section is, at best, contradictory and indeterminate. There are two statements to be found that might be germane. One appeared in both the Senate and House Reports:

> Though § 541 will include choses in action and claims by the debtor against others, it is not intended to expand the debtor's rights against others more than they exist at the commencement of the case. For example, if the debtor has a claim that is barred at the time of the commencement of the case by the statute of limitations, then the trustee would not be able to pursue that claim, because he too would be barred. He could take no greater rights than the debtor himself

had. S. Rep. No. 95-989, at 82 (1978), H.R. Rep. No. 95-595 at 367-68 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963,6323.

In isolation, this general statement largely states the obvious. As recognized in *Buttner*, ordinarily one looks simply to nonbankruptcy law to determine the rights of the debtor against others. Ordinarily, statutes of limitation in no way offend federal policy. The statement says nothing about the exceptional case wherein simple application of state law might so offend.

The second relevant statement came later. In describing the final amendments that conformed the house and Senate bills to one another, Congressman Edwards stated:

> As section 541(a)(1) clearly states, the estate is comprised of all legal or equitable interests of the debtor in property as of the commencement of the case. To the extent such an interest is limited in the hands of the debtor, it is equally limited in the hands of the estate *except to the extent that the defenses which are personal against the debtor are not effective against the estate*. 124 Cong. Rec. H11, 1096 (daily ed. Sept 28, 1978)[4] (Emphasis added.)

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[4] This statement by Congressman Edwards immediately followed a description of § 541(d), which states that where a debtor held only bare legal title without any equitable interest, the estate acquires only bare legal title. *Id.* That is, the defense that the debtor held only bare legal title would be assertable against the trustee. Congressman Edwards' subsequent reference explicitly to subsection (a)(1), rather than the narrower subsection (d), is much more general, referring not only to the kinds of defenses that are assertable against the trustee, but also to the kinds that are not.

The reference to "personal defenses," while not a well known or defined term, likely refers to equitable defenses such as latches, unclean hands, or *in pari delicto*. It specifically contradicts the earlier unqualified statement. Taken together, these terse and unexplained statements are at best indeterminate. They certainly do not tell us that Congress intended to look slavishly to state law in order to override the importance made clear by this Court of federal bankruptcy policy.

III. PERMITTING CORPORATE MANAGERS AND THEIR THIRD-PARTY COHORTS TO ASSERT THE *IN PARI DELICTO* DEFENSE TO AVOID LIABILITY FOR HARM DONE TO THE BANKRUPT CORPORATION VIOLATES FEDERAL BANKRUPTCY POLICY.

Petitioner has forcefully argued that the decisions below frustrate the Bankruptcy Code's goals of uncovering corporate fraud and thereby maximizing the value of the Bankruptcy estate. Petitioner's Brief at 10-11. Petitioner has also argued, as have many others, that it is not in the public interest to bind the trustee to the personal defenses to which the corporation might be subject pre-petition. This is because the trustee, as representative of innocent creditors and investors, stands to receive no personal benefit from the claim, and thus should not be tainted by the wrongful acts of the managers imputed to the corporation. This is also consistent with federal securities and antitrust law, in which federal policy prohibits use of the *in pari delicto* defense to undermine federal goals. Petitioner's Brief at 14-21. Petitioner also argues that applying the *in pari delicto* defense to the trustee encourages corporate malfeasance. Petitioner's Brief at 26-27.

The above arguments need not be repeated here. A few additional points, however, are worth noting. First, it is important to recognize that the lower courts in this case have dismissed the trustee's case against two different types of defendants: The corporate managers who allegedly breached their direct fiduciary obligations to the debtor, and also the third parties, such as accountants and lawyers, who may also be fiduciaries, whose assistance and cooperation facilitated the fraud. It is bad enough that these third-party abettors have been permitted to escape liability by imputing the wrongdoing of the managers to the trustee. Clearly this encourages such third-party facilitation, violating both public corporate and bankruptcy policy. Yet it is even more monstrous to permit the managers themselves to set up *their own* wrongdoing as a defense to liability for those precise wrongful acts. What is the point of a fiduciary obligation, or any obligation at all, if its breach imputes its own defense to breach? No Circuit Court of Appeals other than the Ninth has gone this far.

One final point is worthy of mention. As has been discussed at length, it is well settled that if a receiver had been appointed under state law to represent the innocent creditors and investors, the *in pari delicto* defense would not be available. *See* Judge Posner's "evil zombie" quote taken from *Scholes v. Lehman,* 56 F.3d 750, 754 (1995), Petitioner's Brief at 16. The defense is only available in bankruptcy, it is said, because § 541(a)(1) requires it by defining property of the estate to include property of the debtor "as of commencement of the case." As has been stated above, this reasoning is flawed because this phrase is intended simply to exclude from the estate property acquired after commencement, and it is not intended to overrule this Court's well-settled case law. An additional flaw in the reasoning is a practical one: If Crown were to bring suit in state court against its managers and their third-party abettors,

the *in pari delicto* defense would very likely *not* be available because Crown would inevitably have to be represented in a state insolvency proceeding by either a receiver or an assignee for the benefit of creditors. Recall that Crown had been driven deeply into insolvency by its managers, who would not be likely to bring suit against themselves. Vindication under state law for innocent creditors and investors would be possible only by making use of the state law procedures designed for such circumstances, receivership and assignment for the benefit of creditors. Accordingly, once a disinterested representative of the innocent victims takes the helm, Crown is no longer the evil zombie of its managers, and the defense is no longer available.

In sum, the theory that the defense should be available against the trustee because it would have been available against the corporation as of the commencement of the case is wholly theoretical, fanciful, and impracticable in the extreme. The result below and its reasoning are wholly unjustified. This Court should not permit it to stand.

CONCLUSION

For the foregoing reasons, Amicus Curiae, NABT, respectfully requests that a writ of certiorari be granted.

Respectfully submitted,

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